national news | by mark knold, senior economist

Inflation Fears Becoming an Economic Hurdle

The U.S. economy performed well in the first quarter of 2006. Gross Domestic Product (GDP) growth was a resounding 5.6 percent; the unemployment rate has dipped below 5 percent; and the economy has added close to two million new jobs over the past year. While acknowledging the current prosperity, many economists anticipate that GDP will slow as 2006 plays out.

Consumers are the biggest spenders in the economy. In the past several years, consumers used the housing market as their major spending catalyst—taking advantage of rising equity and low interest rates. But with the housing market cooling and interest rates rising, consumers will likely begin to exhibit more caution in their spending.

Oil prices remain high and have the potential to go higher. This keeps import values high and the nation's trade imbalance growing, even with the falling dollar making U.S.-made goods more attractive to overseas consumers.

Inflation concerns are mounting, as evidenced by rising bond yields. The factors that supported low inflation for years are fading. Energy prices are up and looking like they will stay that way. Commodity prices have been consistently high also, although so far, businesses seem to have absorbed that cost themselves. How long will they continue to do so? With the dollar falling, cheap imports are not as cheap as they were. The dollar is expected to stay down and possibly fall more. This makes the cheap imports that we have built our materialism around more expensive.

Rising inflation reduces consumer purchases and enhances the possibility of the Federal Reserve raising interest rates further, which, in turn, raises the price that businesses pay to borrow money. However, the business community is flush with cash from persistent high profit margins. Therefore, it is yet to be seen if the rising interest rates producing higher borrowing costs will slow business investments as they historically have—or will businesses circumvent this hurdle by drawing down their wealth of in-house cash to finance their investments and expansions?

Labor costs are accelerating in this low unemployment environment. Over the past ten years, much of the nation's increased labor costs have been offset by productivity gains, thus not forcing businesses to pass on the costs to consumers. Productivity growth remains high but is probably peaking and moving forward. If productivity gains don't offset increasing labor costs, businesses will pass this cost on to the consumer.